



**Asia-Pacific
Economic Cooperation**

**Advancing Free Trade
for Asia-Pacific Prosperity**

APEC Economic Policy Report 2015

Executive Summary

2015 AEPR on Structural Reform and Innovation: Executive Summary

Innovation is key to economic growth and business productivity

Innovation is far broader than invention, technology or research and development. While innovation is widely acknowledged as a key driver of growth, the links between structural reform and innovation have yet to be fully explored. This year's APEC Economic Policy Report (AEPR) examines the links between structural policy settings and firm-level innovation across APEC member economies of varying levels of development, and explores the ways in which these economies harness the growth potential that innovation can provide through implementation of effective structural policies. Twenty Individual Economy Reports (IERs) were submitted by member economies providing overviews of their structural policy mechanisms.

Structural policies have a significant role in promoting firm innovation

Chapter 1 of the AEPR describes the key theories of innovation, the measurement frameworks for innovation, and the implications for structural policies.

Innovation is a dynamic process, and is also path-dependent on individual economies' capabilities. At the firm level, innovation has a major effect on productivity and therefore growth. Continued innovation is important to the ongoing survival of firms.

Structural policy settings matter because they can encourage or hinder innovation by influencing where and how much innovation occurs. In the context of the AEPR, structural policy refers to competition policies, regulatory policy (including ease of doing business), corporate law and governance, and public sector governance. While intellectual property is also important for innovation, it is not examined in this year's AEPR as there is already a wealth of well-established literature on this area, and it is largely outside the scope of the Economic Committee's work programme.

Governments can affect variables such as risk, market opportunity, and availability of funding, and therefore, the level of innovation in an economy. Governments need to identify and recognise the effects their policies have on innovation so that they can mitigate or remove impediments to firm-level innovation.

Chapter 2 of the AEPR summarises the key findings from the IERs and highlights interesting and emerging practices in each of the areas of structural policy.

Regulatory policy can stimulate innovation both directly and indirectly

Regulatory policy has direct links to innovation through areas such as technology standards and administrative simplification and indirect links through policy that improves competition, which in turn is associated with higher levels of innovation and economic growth.

Administrative simplification can directly improve innovation

All APEC economies reported using various good regulatory practices which will enable innovation although the precise details, and stages of development, varied from economy to economy. Programmes that emphasise administrative simplification and red tape reduction are almost universal. As economies develop beyond improving the transactional efficiency of their regulatory environment, technology will increasingly drive economies' simplification programmes for their engagement with business.

Regulatory impact analysis (RIA) is now widely used in APEC. As RIA systems become embedded within an economy, the focus should shift towards developing and strengthening specialised areas of

analysis, such as competition principles. Some economies also utilise the expertise of other departments when undertaking specialised areas of assessment, such as the competition effects of regulatory changes. This can increase the robustness of RIA.

Flexible regulatory approaches can promote innovation

A regulatory system which allows and encourages situation-specific regulatory initiatives (e.g. performance based standards or other flexible regulatory approaches) will support innovative regulatory practices. Innovation is directly enabled when the regulatory system is flexible enough to permit alternative technological solutions under prescriptive regulation, or performance-based standards. While some economies have taken the lead in requiring alternatives to prescriptive regulation to be developed, these approaches have yet to be fully adopted in other economies.

As regulatory institutions improve, arrangements to support innovative approaches are enhanced. Continuing to explore and tailor regulatory approaches to the specific challenges faced by an economy will support innovation.

Competition policy is an important driver of innovation

The pursuit of competitive advantage drives new ways of doing things. Introducing competition into less competitive markets can directly boost innovation. Increased competition drives innovation by encouraging firms to adopt improved technology and organisational arrangements, promoting the diffusion of innovations and encouraging resources to be invested in innovation.

Competition policies generally have comprehensive coverage and include technical efficiency

In order for competition to stimulate innovation, the coverage of competition policy should be as wide as possible, and also consider longer-term technical efficiencies from new technologies. In APEC economies the coverage of competition policy is generally comprehensive with limited defined exemptions such as for organised labour or industries that are directly regulated. There has also been increased recognition that competition policy needs to be able to respond to technological advances and technical efficiency gains, as well as allocative efficiency and consumer protection.

The focus of competition policy could be more strategic

To promote innovation, the design of competition policies and enforcement programmes should focus on making highly uncompetitive industries and monopolies more competitive. There were a wide range of responses on the focus of competition policy in APEC economies. The main gains in improving innovation and economic performance come from introducing greater competition into highly uncompetitive industries.

There is scope in APEC to further refine the focus of competition policy. Competition authorities in advanced economies are developing a more strategic focus in their competition policy to identify and improve inefficient markets. These economies are conducting market studies and accessing information held by other government departments to gather this sophisticated market intelligence. As economies develop, the challenge is examining whether their current competition policies, laws and institutions continue to be fit-for-purpose in the face of emerging new technologies.

Corporate law and governance frameworks enable innovation

Corporate law and governance play a key enabling role for innovation. The government's role is to establish the relevant corporate governance frameworks, including the rules around the formation, restructuring and wind-up of companies through corporate law, securities law, share market regulation, and insolvency and bankruptcy law.

APEC economies recognise the role of directors in ensuring good corporate governance

While competition in product markets helps to discipline poor managers, the role of directors in ensuring good corporate governance and shaping management's approach to innovation is also important. The most common mechanism in APEC economies is the director's duty to act in the interests of the company or its shareholders, coupled with the ability for shareholders to take legal action for breaches of directors' duties. All economies recognise that an appropriate balance needs to be struck between risk-taking and shareholder/creditor protection.

'Ease of Doing Business' programmes (in particular the priority areas of starting a business, getting credit, dealing with permits, enforcing contracts, and trading across borders) are widespread throughout APEC. They assist innovation by smoothing the transitions in the life cycles of businesses and improving the operation of corporate governance policies.

One promising practice is greater flexibility in financing start-ups

The forms of capital raising vary significantly at different levels of development, with advanced economies offering a greater range of options for capital raising. An emerging practice among these advanced economies is the development of legal mechanisms for raising capital by crowdfunding. This enables micro and small innovative enterprises to raise capital from the public to invest in their projects or ventures (providing an alternative means to banks and finance companies).

As economies develop, there appears to be increased focus on enabling a range of options for capital raising, particularly for new innovative firms. All economies recognise the need for incentives to ensure directors act in the long-term interests of shareholders, including by ensuring that adequate firm strategies for innovation are in place.

Public sector governance affects innovation capability

Good public policies that are effectively delivered are an important enabler for innovation. Governments can have a major impact on innovation by providing a stable and predictable legal framework, and through the specific national innovation system.

The quality of public institutions has a key role in setting the overall rules of the game

The quality of public institutions affects the overall capability of the national innovation system. The government has a key role in developing property rights and the rule of law applying to capital, labour and product markets. The stability and predictability of public sector institutions is important because innovation is inherently uncertain and risky.

Legal frameworks are widespread but the application of the rule of law is uneven across APEC. Many developing and middle income economies still struggle to achieve a stable and predictable rule of law regime, despite having the right legal frameworks in place.

As economies become more developed, the role of State Owned Enterprises (SOEs) in the economy declines. In advanced economies, the remaining SOEs generally operate on a level-playing field with private businesses so these SOEs can operate successfully in competitive markets.

Economies are continuing to experiment with improvements in the national innovation systems

Specialist non-market bodies play an important role in the national innovation system, being tasked with and capable of delivering innovation policy, knowledge infrastructure (universities and research institutes), and innovation infrastructure (provided by standards bodies, patents offices etc.). The

knowledge and innovation infrastructures within APEC economies are predominantly publicly owned and funded.

Across APEC, there is a lack of specialist non-market entities tasked explicitly with encouraging private sector innovation. While economies are continuing to develop and improve their national innovation systems, a recurring challenge is the lack of coherence and integration between the different parts of the innovation system.

Economies face different innovation challenges at different levels of development

The demands placed on an economy's structural policy frameworks will change as an economy moves through different stages of economic development. Once an economy establishes basic institutions, its focus will increasingly shift to developing the internal capability to support these institutions. As institutions mature, internal capability becomes a more important factor in driving ongoing success and creating an environment to foster innovation.

Economies at various stages of development will face different challenges in developing the right mix of structural reform policies to support innovation within their economy. There is no 'one size fits all' approach. Economies will need to tailor policy reforms to reflect their individual circumstances and challenges. In many instances, factors such as proximity to export markets, domestic market size or structure, and factor endowments will exert a significant influence on an economy's innovation ecosystem.

Given the complexity of some reform processes, economies may focus on reforms that address the largest impediments to economic growth and seek to build on them through further policy reform and capacity building initiatives.

An in-depth look at how competition policy can promote innovation

Chapter 3 consists of a case study by the Philippines on the links between competition policy and innovation. This follows the passage of the Philippine Competition Act in July 2015. Four elements of competition policy are seen as critical to promote innovation:

- It takes into consideration technical and dynamic efficiency.
- There is a broad coverage of the law.
- The competition authority is independent, accountable and transparent.
- There is coherence between competition policy and other economic policies such as sectoral regulation.

These elements are particularly challenging for young competition agencies. They may face difficulties in obtaining sufficient resources and expertise, as well as being impacted by a lack of awareness of competition issues among other government agencies, the judiciary and the public.

International forums provide opportunities for information exchanges between competition agencies, but the returns to APEC are likely to be greater if targeted initiatives to assist young agencies are pursued. Actions that APEC can take to build capacity of less experienced competition authorities include developing guidelines to help them assess competitive harm and evaluate potential dynamic efficiency gains from particular conduct, and undertaking a campaign to raise the level of understanding of competition policy in government agencies not directly involved in competition governance.

Economies are making progress in developing policies to support innovation

The AEPR concludes in Chapter 4 that firm innovation provides another lens through which governments can consider the impact of structural policies and examine areas where reform may be required.

While economies face different challenges depending on their level of development, it is crucial to focus policy and administrative improvements on the binding constraint to innovation so the structural changes introduced will make the greatest difference. It is also worth noting that the nature of firm innovation will differ depending on the level of development, whether this comprises faster rates of technological catch-up amongst developing economy firms, or pushing out technological frontiers amongst developed economy firms.

The AEPR reaches three further conclusions. Firstly, it is clear that there is significant diversity even between economies at the same levels of development. Secondly, structural policies have a critical role in supporting the development of high performing national innovation systems tailored to each economy's unique circumstances. Thirdly, all economies, no matter their level of development, face capability challenges in developing the policies and institutions that will improve firm innovation outcomes. It is important for all economies to be realistic about their capability needs and to have strategies in place that will allow them to build capability over time.

Recommendations

It is recommended that the Senior Officials' Meeting (SOM) recommend that APEC Ministers:

- (a) Endorse the 2015 AEPR on Structural Reform and Innovation;
- (b) Instruct the Economic Committee to take account of the findings of this Report in developing its structural reform work programmes, particularly in the Renewed APEC Agenda for Structural Reform (RAASR) and Ease of Doing Business (EoDB); and
- (c) Instruct the Economic Committee to transmit and discuss the contents of this report with other APEC bodies with an interest in structural reform and innovation.



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